

REPORT OF EXAMINATION
OF THE
MONTEREY INSURANCE COMPANY

AS OF
DECEMBER 31, 2003

Participating State
and Zone:

California

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
COMPANY HISTORY	2
MANAGEMENT AND CONTROL:	2
Intercompany Agreements	4
TERRITORY AND PLAN OF OPERATION	4
REINSURANCE:	5
Inter-company Reinsurance Pooling.....	5
Assumed.....	6
Ceded	6
ACCOUNTS AND RECORDS:.....	8
Information System Controls	8
FINANCIAL STATEMENTS:	8
Statement of Financial Condition as of December 31, 2003	9
Underwriting and Investment Exhibit for the Year Ended December 31, 2003.....	10
Reconciliation of Surplus as Regards Policyholders from December 31, 1998 through December 31, 2003.....	11
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	12
Losses and Loss Adjustment Expenses	12
SUMMARY OF COMMENTS AND RECOMMENDATIONS:.....	12
Current Report of Examination.....	12
Previous Report of Examination.....	13
ACKNOWLEDGMENT.....	14

San Francisco, California
July 27, 2004

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable John Morrison
Secretary, Zone IV - Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of

MONTEREY INSURANCE COMPANY

(hereinafter referred to as the Company) at its home office located at 2300 Garden Road, Monterey, California 93940.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1998. This examination covers the period from January 1, 1999 through December 31, 2003. This examination was conducted pursuant to the National Association of Insurance Commissioners' plan of examination.

The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances. The examination was conducted concurrently with the Company's affiliates, California Capital Insurance Company and Eagle West Insurance Company.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; loss experience; business in force by states; and sales and advertising.

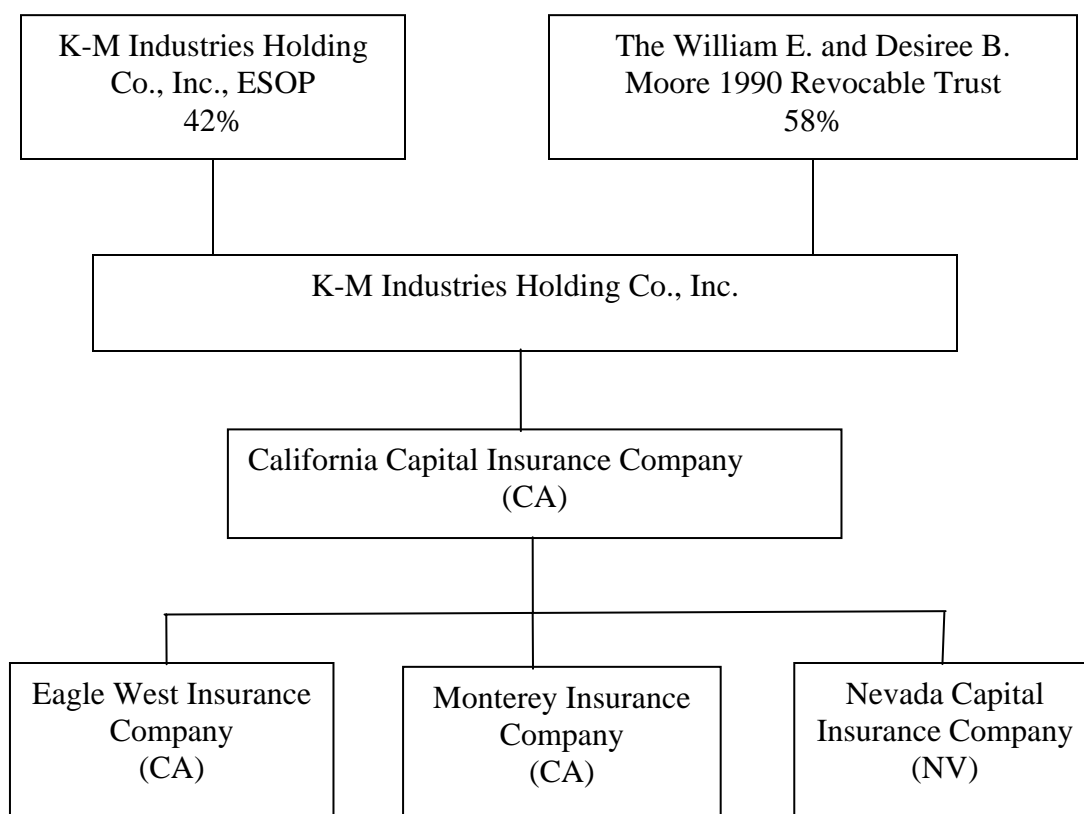
COMPANY HISTORY

The Company was incorporated as a property and casualty insurer on July 7, 1987 under the laws of the State of California and began business on September 15, 1988. California Capital Insurance Company formed the Company and also holds direct financial control of the Company.

On October 18, 1999, an Employee Stock Ownership Plan (ESOP) was implemented with the purchase of 42% of the Series "I-B" Tracking Stock of K-M Industries Holding Co., Inc. The William E. Moore and Desiree B. Moore 1990 Revocable Trust retained 58% ownership.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which William E. and Desiree B. Moore are the ultimate controlling persons. The following chart depicts the interrelationship of the companies within the holding company system:



Directors

Name and Residence

Peter M. Cazzolla
Carmel Valley, California

William E. Moore
Woodside, California

Desiree B. Moore
Woodside, California

Principal Business Affiliations

Chief Executive Officer and President
California Capital Insurance Company

Chairman of the Board
K-M Industries Holding Co., Inc.

Director
K-M Industries Holding Co., Inc.

Principal Officers

<u>Name</u>	<u>Title</u>
Peter M. Cazzolla	Chief Executive Officer and President
Edward T. Mines	Vice President, Finance, Secretary and Treasurer
Thomas H. Scherff	Vice President of Claims
Robert D. Winn	Vice President of Underwriting and Field Operations

Intercompany Agreements

Allocation of Federal Income Taxes Agreement: This agreement is between Kelly-Moore Paint Company, Inc. and California Capital Insurance Company (CCIC) and its subsidiaries, Eagle West Insurance Company (EWIC), the Company, and Nevada Capital Insurance Company (NCIC). It provides for allocation of the year-end consolidated tax liability among participants in the agreement. The year-end tax liability is computed on a consolidated basis; however, each participant's tax provision is calculated individually.

Management Services Agreement: This agreement is between CCIC and its subsidiaries, EWIC, the Company and NCIC. Under the terms of the agreements, CCIC provides sales, reinsurance, underwriting, claims payments, investment and various other administrative services to its subsidiaries based on actual cost. This agreement was submitted to the California Department of Insurance when NCIC was added to the reinsurance agreement in 2002.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2003, the Company was licensed to transact business in Arizona, California, Montana, Nevada, and Oregon.

Direct premiums in 2003 totaled \$17.2 million, of which 99% were written in California. The principal direct lines of business written during 2003 were commercial auto liability (59%), commercial multi-peril (27%), inland marine (5%) and auto physical damage (5%). The Company

also writes smaller amounts of fire, allied lines, earthquake, other liability-occurrence, burglary, and boiler and machinery insurance.

Business for the Group is produced entirely by independent agents and brokers. There were approximately 335 agents and 2 brokers appointed by the Company as of the examination date.

The Company operates on a joint basis with its parent, California Capital Insurance Company (CCIC) and its affiliates, Eagle West Insurance Company (EWIC) and Nevada Capital Insurance Company (NCIC) pursuant to an inter-company reinsurance pooling agreement. Each company uses a different marketing approach. CCIC and EWIC write all standard lines of business on a preferred basis. The Company writes direct commercial multiple peril business at deviated rates. NCIC writes policies only in Nevada.

Underwriting for personal lines is performed at the Company's home office. Commercial lines underwriting is done at the branch level for amounts within the authority of the branch. Larger policies are underwritten at the home office. Underwriting for farm business is done exclusively at the Modesto branch.

In addition to a claims office in Bakersfield, California, the Company has branch offices in Anaheim, Camarillo, Ferndale, Modesto, Monterey, Sacramento, San Diego, and San Jose, California.

REINSURANCE

Inter-company Reinsurance Pooling

Effective January 1, 1989, the Company entered into a quota-share reinsurance pooling agreement with California Capital Insurance Company (CCIC) and Eagle West Insurance Company (EWIC) to combine and distribute the results of each company's underwriting operations. The agreement authorizes the Company to collect and receive all premiums, to adjust and pay all losses and to reinsure or cancel all contracts and policies for the pool. Nevada Capital Insurance Company (NCIC)

was added to the agreement effective January 1, 2002. The Company, EWIC and NCIC cede 100% of all premiums, losses, loss adjustment expenses and most of the underwriting expenses to CCIC, which then retrocedes a prorated amount to each company based on the following pool percentages:

California Capital Insurance Company	70%
Eagle West Insurance Company	10%
Monterey Insurance Company	10%
Nevada Capital Insurance Company	<u>10%</u>
Total	100%

This agreement was determined to be in compliance with applicable statutes of the California Insurance Code and approved by the California Department of Insurance.

Assumed

The Company did not assume any business during the period under examination.

Ceded

The following is a summary of principal reinsurance agreements in effect as of December 31, 2003. All reinsurers are authorized unless indicated otherwise. Reinsurers with less than 5% participation have been accumulated and listed in aggregate.

<u>Type of Contract</u>	<u>Reinsurer(s)</u>	<u>Company's Retention</u>	<u>Reinsurer's Limits</u>
<u>Property Excess</u>			
First Layer Excess	Motors Insurance Corporation	\$500,000 per risk	\$250,000 per risk and \$750,000 per occurrence
Second Layer Excess	Motors Insurance Corporation	\$750,000 per risk	\$250,000 per risk and \$750,000 per occurrence
Third Layer Excess	Motors Insurance Corporation	\$1,000,000 per risk	\$5,000,000 per risk and \$10,000,000 per occurrence
<u>Casualty Excess</u>			
First Layer Excess	Motors Insurance Corporation	\$500,000 per occurrence	\$250,000 per occurrence

<u>Type of Contract</u>	<u>Reinsurer(s)</u>	<u>Company's Retention</u>	<u>Reinsurer's Limits</u>
Second Layer Excess	Motors Insurance Corporation	\$750,000 per occurrence	\$250,000 per occurrence
Third Layer Excess	Motors Insurance Corporation	\$1,000,000 per occurrence	\$5,000,000 per occurrence
<u>Property Catastrophe Excess</u>			
First Layer Excess	Mapfre Reinsurance Corporation (10%) Odyssey America Reinsurance Corporation (6%) PXRE Reinsurance Corporation (6%) Lloyd's Syndicate #2001 (15%) Various companies (4.0) Nonadmitted: Arch Reinsurance Company (5%) Axis Specialty Limited (20%) Hannover Re (Bermuda) Ltd. (8%) Montpelier Reinsurance Limited (6%) SPS Reassurance (15%) Various companies (5%)	\$5,000,000	95% of \$5,000,000 per occurrence (annual limit of 95% of 10,000,000)
Second Layer Excess	Converium Reinsurance Inc. (10%) Lloyd's Syndicate #2001 (15%) Various companies (12%) Nonadmitted: Arch Reinsurance Company (5%) Axis Specialty Limited (20%) Hannover Re (Bermuda) Ltd. (6%) Montpelier Reinsurance Limited (6%) Platinum Underwriters Reinsurance, Inc. (5%) SPS Reassurance (9%) Various companies (5%)	\$10,000,000	95% of \$10,000,000 per occurrence (annual limit of 95% of \$20,000,000)
Third Layer Excess	Coverium Reinsurance Inc. (10%) Mapfre Reinsurance Corporation (9%) Lloyd's Syndicate #2001 (15%) Various companies (10%) Nonadmitted: Arch Reinsurance Company (5%) Axis Specialty Limited (18%) Hannover Re (Bermuda), Ltd. (6%) Montpelier Reinsurance Limited (6%) Platinum Underwriters Reinsurance, Inc. (5%) SPS Reassurance (9%) Various companies (7.0%)	\$20,000,000	95% of \$15,000,000 per occurrence (annual limit of 95% of \$30,000,000)

<u>Type of Contract</u>	<u>Reinsurer(s)</u>	<u>Company's Retention</u>	<u>Reinsurer's Limits</u>
Top Layer Excess	Mutual Reinsurance Bureau: Employers Mutual Casualty Company (25%) Farmers Mutual Hail Insurance Company of Iowa (25%) Nonadmitted: Auto-Owners Insurance Company (25%) Motorists Mutual Insurance Company (25%)	\$35,000,000	100% of \$15,000,000 per occurrence not to exceed 100% of \$30,000,000 with respect to all occurrences during each contract year

ACCOUNTS AND RECORDS

Information System Controls

A review was made of the Company's general controls over its information systems. As a result of the review, weaknesses were noted in areas such as operations controls and logical access controls. The weaknesses noted were presented to the Company along with recommendations to strengthen its controls. The Company agreed to evaluate these recommendations and make appropriate changes to strengthen its information systems controls.

In 1998, the Company implemented a new claims database system. At that time, historical claim data was not carried over to the new system, though accounting still tracked this data. It is recommended in future application changes that historical data be transferred to any new applications.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders from December 31, 1998 through December 31, 2003

Statement of Financial Condition
as of December 31, 2003

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 29,986,672	\$	\$ 29,986,672	
Cash, cash equivalents and short-term investments	1,112,594		1,112,594	
Investment income due and accrued	330,378		330,378	
Uncollected premiums and agents' balances in course of collection	877,883	24,076	853,807	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	1,870,518		1,870,518	
Amounts recoverable from reinsurers	37,382		37,382	
Net deferred tax asset	1,068,400	124,100	944,300	
Receivable from parent, subsidiaries and affiliates	479,305		479,305	
Aggregate write-ins for other than invested assets	<u>64,821</u>	<u>45,365</u>	<u>19,456</u>	
Total assets	<u>\$35,827,953</u>	<u>\$ 193,541</u>	<u>\$35,634,412</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 6,893,200	(1)
Loss adjustment expenses			2,881,546	(1)
Commissions payable, contingent commissions and other similar charges			1,027,876	
Other expenses			325,275	
Taxes, licenses and fees			142,609	
Federal and foreign income taxes			29,086	
Unearned premiums			9,836,573	
Advance premiums			232,704	
Ceded reinsurance payable			411,726	
Drafts outstanding			692,890	
Payable for securities			<u>1,087,275</u>	
Total liabilities			23,560,760	
Common capital stock		\$ 2,600,000		
Gross paid-in and contributed surplus		440,180		
Unassigned funds (surplus)		<u>9,033,472</u>		
Surplus as regards policyholders			<u>12,073,652</u>	
Total liabilities, surplus and other funds			<u>\$35,634,412</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income

Premiums earned	\$19,054,819
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Deductions:

Losses incurred	\$9,761,514
Loss expenses incurred	2,305,710
Other underwriting expenses incurred	<u>6,890,819</u>

Total underwriting deductions	<u>18,958,043</u>
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Net underwriting gain	96,776
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Investment Income

Net investment income earned	\$1,429,956
Net realized capital gains	<u>68,836</u>

Net investment gain	1,498,792
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Other Income

Net loss from agents' or premium balances charged off	\$ (24,438)
Finance and service charges not included in premiums	162,392
Aggregate write-ins for miscellaneous income	<u>5,502</u>

Total other income	<u>143,456</u>
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Net income before dividends to policyholders and before federal and foreign income taxes	1,739,024
Federal and foreign income taxes incurred	<u>811,594</u>

Net income	<u>\$ 927,430</u>
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Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002	\$10,880,809
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Net income	\$ 927,430
Change in net deferred income tax	254,900
Change in nonadmitted assets	<u>10,513</u>

Change in surplus as regards policyholders for the year	<u>1,192,843</u>
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Surplus as regards policyholders, December 31, 2003	<u>\$12,073,652</u>
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Reconciliation of Surplus as Regards Policyholders
from December 31, 1998 through December 31, 2003

Surplus as regards policyholders, December 31, 1998, per Examination	\$ 9,295,331
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	Gain in Surplus	Loss in Surplus
Net income	\$ 1,867,287	\$
Change in net deferred income tax	635,900	
Change in nonadmitted assets		157,366
Cumulative effect of change in accounting principle	432,500	
Total gains and losses	\$ 2,935,687	\$ 157,366

Increase in surplus as regards policyholders	<u>2,778,321</u>
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Surplus as regards policyholders, December 31, 2003, per Examination	<u>\$ 12,073,652</u>
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COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The Company is not in compliance with SSAP 65, Property and Casualty Contracts, paragraph 32, because the scope paragraph of the Actuarial Opinion does not include the Reserve for Ceded Unearned Premiums, the Reserve for Direct Unearned Premiums, and the Reserve for Net Unearned Premiums. These three items are not covered elsewhere in the opinion and no disclosure has been made regarding the provision for investment income in the projected future losses and expenses for unexpired policies and the amount of reduction in unearned premium and loss reserves for salvage and subrogation, reinsurance, credits for deductibles and self insured retentions, and other statutory approved credits. It is recommended the Company comply with SSAP 65, paragraph 32. The Company is contacting its independent actuary to correct this issue.

The California Department of Insurance (CDI), pursuant to California Insurance Code Section 733(g), retained an independent actuary for the purpose of providing a full actuarial evaluation of the Company's loss and loss adjustment expense reserves as of December 31, 2003. Based on the evaluation and the review of the work by a Casualty Actuary from the CDI, the Company's December 31, 2003 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records - Information Systems Controls (Page 8): It is recommended that the Company evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information system controls. The Company agreed to evaluate these recommendations and make appropriate changes to strengthen its information systems controls.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 12): It is

recommended that the Company Comply with SSAP 65, paragraph 32. The Company is contacting its independent actuary to correct this issue.

Previous Report of Examination

Management and Control - Management Arrangements (Page 4): It was recommended that the Company revise the “Allocation of Federal Income Taxes Agreement” to address the treatment of net operating losses and other similar items such as net capital losses which are applied on a consolidated tax return but not eligible for application on an a separate return basis. The Company has implemented this recommendation.

Reinsurance - Ceded (Page 6): It was recommended that the Company amend its reinsurance agreements to meet the requirements of California Insurance Code Section 922.2(a) (2), to exclude punitive damages for California risks and to comply with Chapter 22 of the NAIC Accounting Practices and Procedures Manual. The Company is now in compliance.

Accounts and Records – Financial Reporting (Page 9): It was recommended that the Company implement procedures to ensure accurate financial reporting. The Company has implemented this recommendation.

Accounts and Records - Information Systems Controls (Page 10): It was recommended that the Company evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information system controls. Similar deficiencies were noted during the current examination.

Comments on Financial Statement Items – Bonds (Page 15): It was recommended that the Company use market values published by the NAIC’s Securities Valuation Office. The Company has implemented this recommendation.

Comments on Financial Statement Items – Premiums and Agents’ Balances in Course of Collection (Page 15): It was recommended that the Company age premiums and agents’ balances in course of

collection in accordance with the NAIC Accounting Practices and Procedures Manual. The Company has implemented this recommendation.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

Susan Bernard, CFE
Senior Insurance Examiner
Examiner-In-Charge
Department of Insurance
State of California